DOW THEORY LETTERS INC.

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This is a special Letter. If there are typos, please excuse us. Why a special? Because certain ideas have clarified in my mind, ideas that I introduced in the last few letters, and I want to get them to you now. I do change and alter my ideas — that's why I publish 36 Letters a year instead of a dozen!

"Consider the work of God; who can set straight what he has made crooked? When times are prosperous, enjoy your happiness; when times are bad, consider this: The one is God's doing, as is the other, in order that man may know nothing of his destiny. . . ." Ecclesiastes 7:13

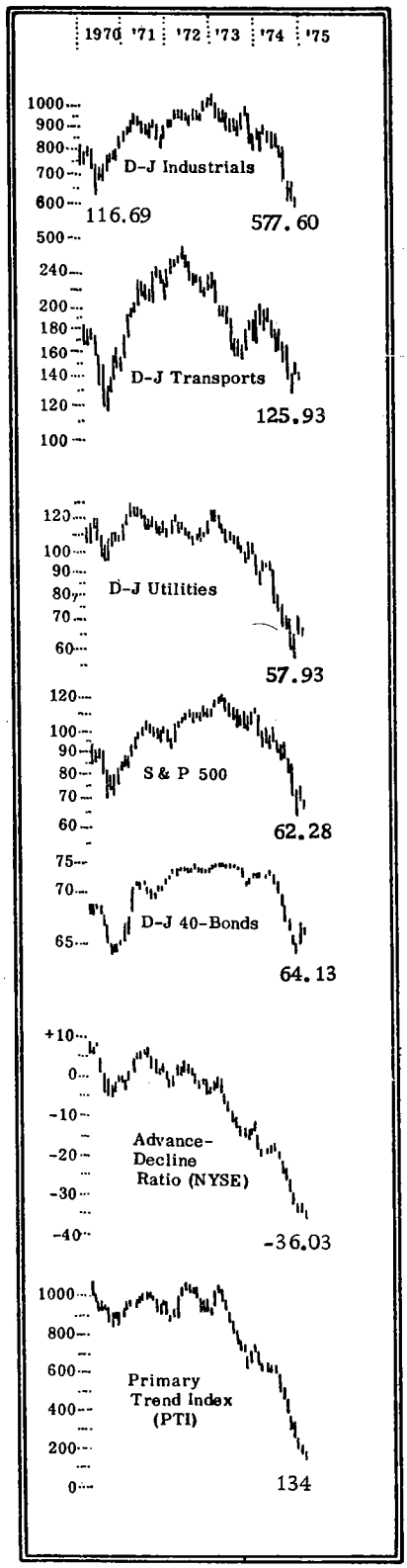
THE MARKET: Like the Biblical writer above, we know little of our personal destiny or our investment destiny. I have succeeded so far in keeping my subscribers out of the worst market collapse since 1929-32. For eight years I have held steady to a policy of cash (or Treasury bills), gold shares and unlimited patience. I presume that I must have done something right, because over the past year (during these most difficult times) subscriptions to this report have doubled, taking them to the highest level in seventeen years.

I am most grateful to my veteran subscribers and to my many new ones. I know that in a time of recession, universal gloom and shattering losses, a check for $95 for an investment service is not an easy thing to part with. I hope that some of the market losses that were avoided (if you followed my advice) more than make up for the cost of a subscription. At any rate, I find that I am sweating just as much this year as last. And that isn't because of the increased subscription list, it's because Wall Street isn't getting any easier (or perhaps I'm not getting any smarter).

On to the market: Turning to the long chart on page 1, let's see what is happening to the various indices and averages which we are using to measure the depth (or the death) of the great bear. On December 13 and again on December 16 the Primary Trend Index or PTI (which is my own composite of eight critical indices and averages) recorded brand new bear market lows. On December 16 the advance-decline ratio for the NYSE recorded another bear market low. But note that none of the Averages, our gauges of the actual price movement, have confirmed on the downside.

As a rule, the longer a primary trend is in force, the less the significance of preceding points in the Averages. Thus, I show a bear market low of 116.69 in 1970 for the D-J Transports. Four years have elapsed since that low, and I therefore do not accord too much importance to that earlier low. However, the Transports struck a low of 125.93 on October 3, 1974. One day later (Oct 4) the Industrials touched a low of 584.56. On December 6 Industrials broke to a new bear market low of 577.60 (see page 1 chart). Transports have not yet confirmed. This could prove to be very significant. Time will tell. Also on the significant list is the fact that so far, the D-J Utilities, the D-J Bonds and the S & P 500 Average have refused to confirm the December 6 low on the Dow. The longer this condition prevails, the more hopeful the overall picture for the market in general.

Question: Russell, are you saying that we could have seen a major bear market bottom? Answer: I'm saying that it is possible, that I now feel better than 50/50 about it. Frankly, there are a number of phenomena I would like to see, but as I have said so often, they don't run the market for Richard Russell. For instance, I would like to see much more odd-lot shorting, I would like to see more skepticism on the part of advisories concerning the periodic rallies. I would like to see even blacker sentiment (regarding securities) than we now see. I would like to see the Averages form a dragging, low-volume bottom. I would like to see stocks act totally immune to bad news (although they still get hit somewhat when bad news emerges).



 Question: Russell, I want to pin you down. Do you think we have seen the bottom? Answer: You're asking me a question that I have no right to answer at this time. Remember, after eight years of "promising" my readers that the market was most definitely going lower, I have now decided to let the market show me that it is or is not going lower. Second point: All bear market bottoms are identified in retrospect (except by those geniuses who call the "bear market bottom" all the way down, and who, like the clock that stopped, are eventually correct).

Subscribers should remember too that it is not necessary to pin-point the ultimate bottom of a bear market. The bottom could be here, it could arrive in a week, a month or six months. We have been in the third phase of the bear market. When the Averages produce a primary bull signal or when our moving averages of the Dow and our Dow momentum turn up, we will know that the tide has turned.

Question: What would a Dow Theory bull signal entail at this point? Answer: The last joint lows in the Averages were recorded October 3 and 4 (see chart 4). Next we had a rally to the November 4 Industrial peak of 674.75 and the November 6 Transport peak of 156.61. A new decline of secondary proportions took Industrials to the recent December 6 low of 577.60. The same decline took Transports to a December 16 low of 138.31.

If any forthcoming advance (and we are now in one) succeeds in taking the two Averages above their November peaks (Industrials 674.75, Transports 156.61) I am going to call a new primary bull market. It's as simple as that.

Question: What do we do if that happens, Russell? Answer: If we get a bull signal, neither I nor any one else on the face of the globe knows how extensive the bull market will be or how long it will last. It could be a five-year whopper or it could be a one-year disappointment (or a one-year explosion for that matter).

At any rate, if we get a bull signal I would recommend moving 25% of your funds into a no-load (no commission) mutual fund as the first move. Individual stocks will then be discussed as we move along. But as to the fund, it should be one that has a good record of performing in an "up market," and I will leave this to you and your broker. (If you haven't got a competent and knowledgeable broker by now, this is the time to get one). I might add that Growth Fund Guide, PO Box 2109, San Clemente, CA 92672, ($39 annually) contains invaluable research on the "growth funds".

Question: Suppose one or both of the Averages refuse to better the 674.75 (Industrial) and 156.61 (Transport) high of November, 1974 and they then turn down and break to new bear market lows? Answer: If that happens, we're still in the bear market's third phase.

Question: What about buying some stocks now? Is it necessary to get proof of a new bull market before buying? Answer: Nothing in Dow's Theory states that it is necessary to wait for a Dow Theory bull signal before buying. The bull signal represents technical confirmation that we were correct — that a bear market bottom indeed did occur.

Now this is how I view it. I think the odds are probably better than 50/50 that the Dow and most shares hit a bottom in December, 1974. I put this thesis together with a number of other facts. As you will see in a later section, the unweighted NYSE average is now down around 77% from the high. In 1929-32 the unweighted NYSE average went 12% further on the downside — to an 89% loss. I feel that most shares have now discounted all the forthcoming bad news, and I am including recession-depression conditions in 1975. We have been in the third phase of a great primary bear market. We are finally in the zone of "great values". In many cases, stocks are selling "below known values". Here's an interesting statistic: The price/earnings ratio for the 30-Dow Industrials is now around 6.0 while the yield on the Dow is 6.36. This means that the Dow P/E is below the yield on the Dow. This happened only once before in the last forty years, and that was during 1948-50.

Second item: The Dow is now selling below its book (or break-up) value. This has not occurred since 1942. Are these two above Dow "tests" infallible indications of the final bottom? Not at all, but they do indicate that the Dow is sure getting down there.

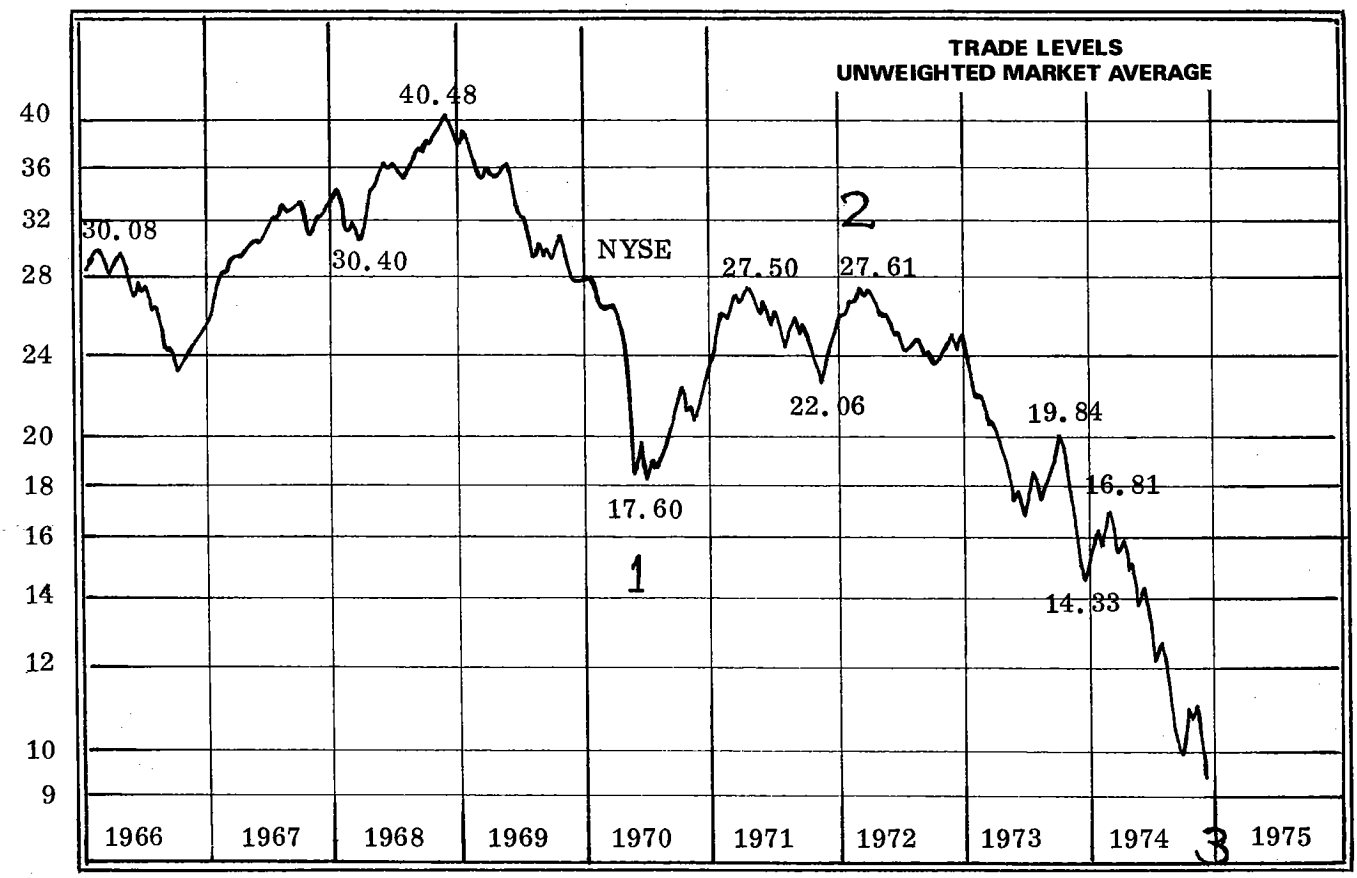
Last week Value Line ran a very clever advertisement. They listed 18 NYSE stocks including such issues as Telex, Ampex, Pan Am, Lockheed, General Steel, Avco, Lear Siegler, United Brands, etc. — eighteen of them. "At their pre-1971 highs, the average price per share for any ONE of these stocks worked out to $50. Today," said Value Lines, "you could buy ALL 18 for less than $50." I read the ad and I said to myself, "Value Line is talking values. I can't argue with that ad."

Many readers may remember the median price study from Letter 599 (a study that I keep abreast of courtesy of Prof. S. L. Davis, Case Western Reserve University). This study shows the median price of all stocks on the NYSE or the middle price. The median price is now 12.3, a fraction off its 1974 low of 12.2. This means that half of the stocks on the NYSE are currently priced below 12.2 and half above 12.2. The lowest point since 1920 for the median was the 7.0 of July 9, 1932.

All right, I've talked about values. The fact is that a very long list of good stocks have lost 75% to 90% of their value. I do not see anything wrong with beginning accumulation in these shares now. I think the downside risk in these shares is very limited. I think a package of five or preferably ten or more of these issues should work out well in the period ahead. I think that even if the Dow breaks again to the tune of another 100 points, these stocks would tend to hold.

Here is a representative list of stocks that I personally like, get your broker on them to find out dividends, earnings, etc. (This is your chance to get your broker to move his fanny!). G.D. Searle, Bell & Howell, Reynolds Metals, Uniroyal, Coca Cola of NY, McGraw Hill, Holiday Inns, Kaiser Cement, Food Fair, Fairchild Industries, Clorox, Miles Laboratory, Cluett Peabody, Spring Mills, Woolworth, General Host, Faberge, Macy's, Miles Laboratory, Pennzoil, Texaco.

Question: Russell, how is it that you don't recommend putting all of your assets into the market on a bull signal? Why not get fully invested? Answer: If you remember, I said in the last Letter that a true bear market goes through intense deflation and liquidation, not only in the stock market (which has already occurred) but in the economy (and this has not occurred). I said that if this economy did not go through the big liquidation, then any bull market that developed could be sub-standard in duration and extent. I feel that a bull market which materialized in this area could be a sort of "abbreviated bull". Therefore, with subscribers still holding 25% in gold items and putting another perhaps 15% to 20% in some of the issues listed above, and finally placing 25% of remaining funds into a no-load fund (on a primary bull signal), I feel we would be in the correct stance. This stance would allow us to gain from a bull market that would almost surely be fueled by a new round of monetary inflation (rather than a bull market that grew out of a natural foundation of intense liquidation and real, pent-up demand).



Question: Russell, what about the panic for cash and the profit collapse which you foresaw for 1975? Answer: They may well be coming, and today's prices may have discounted them. But I never argue with the market, and the fact is that the last confirmed lows in the Averages were made on October 3 and 4 (Industrials 584.56. Transports 125.93). Both Averages have not been lower since. Industrials have been lower, but that constituted a non-confirmation.

The extent of the damage brought in by the bear market is shown in this chart by Trade Levels, 301 E. Colo. Blvd., Pasadena CA 91101. This unweighted chart shows the disastrous story of the last number of years. There's been only one worse collapse in Wall Street history.

The 1-2-3 notations should be clear to all who followed my earlier discussion of the Elliott Wave Principle. Bear markets come in major 1-2-3 waves. According to the chart, this major downward zig-zag could be completed.

Question: What about the gold shares and gold coins, what do we do with them? Answer: My gold share/bullion ratio chart broke up last week in favor of the metal (coins) over the shares (see chart, last Letter). I consider the coins to be a survival hedge, our treasure trove of real, honest-to-God money. The shares should be held for what looks like a move coming up into the first quarter. At that point I will have to make a decision on where we stand with the gold shares. At this point, I would say that the downside for gold shares has been well tested, and that they should be held as a leveraged hedge against what could be coming up in 1975-76, namely, the biggest spate of monetary inflation yet (the December Bank Credit Analyst states that it could take a 20% to 25% expansion of the money supply to move the economy out of this gathering recession). A thought: What happens if the 2 million ounces of gold that the Treasury is "auctioning off" in January is gobbled up? I would say that such action would constitute a big plus for gold (already it is rumored that the Arabs may take the whole batch).

Below are weekly charts of some of the stocks I like. The first figures in the tiny boxes represent the quarterly earnings, the second figures represent earnings for the last four quarters (for instance, CLU shows 10¢ for the third quarter's earnings and 61¢ for the four quarters ending with third quarter 1974 (charts courtesy of Quote, PO Box 213, Wichita, KS 67201).

NOTE: The next Letter will be mailed January 2 unless Wall Street does something so outlandish I have to get out another "special".

In closing, I want to wish my loyal readers all the best for the New Year.